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November 5, 1997

BY HAND DELIVERY

Mr. David Guzy
Chief, Rules and Publications Staff
Royalty Management Program
Minerals Management Service
Building 85
Denver Federal Center
Denver, Colorado 80225



Re: Comments on Proposed Crude Oil Valuation Rule

Dear Mr. Guzy:

Enclosed are two copies of the comments of Mobil Oil Corporation to the Minerals Management Service's September 22, 1997 Federal Register notice captioned "Establishing Oil Value for Royalty Due on Federal Leases." Please file one copy and date-stamp and return the other copy with our messenger.

Sincerely,

A handwritten signature in cursive script, appearing to read "Suzanne M. Bonnet".

Suzanne M. Bonnet

Enclosure

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COMMENTS OF MOBIL OIL CORPORATION
November 5, 1997
on "Establishing Oil Value for Royalty Due on Federal Leases"
Department of the Interior
MINERALS MANAGEMENT SERVICE
62 Fed. Reg. 49460, September 22, 1997

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Mobil Oil Corporation ("Mobil") submits these comments in response to MMS' notice captioned "Establishing Oil Value for Royalty Due on Federal Leases," published September 22, 1997, in the Federal Register ("Supplement").

INTRODUCTION

As Mobil understands the Supplement, MMS has asked for public comment on five alternatives it has received from various participants in the crude oil industry in response to MMS' January 24, 1997, crude oil valuation rule as supplemented on July 3, 1997 (collectively the "Proposed Rule"). MMS is to be commended for its willingness to consider alternatives to what Mobil continues to believe to be the unwarranted, unworkable, and statutorily unauthorized index methodology contained in the Proposed Rule. It is difficult to offer any in-depth comment on each of the proposed alternatives, however, because they are framed in abstract and conclusory terms. From what Mobil has been able to glean from the summaries presented in the September 22 Supplement and the explanations provided at MMS' workshops, there are concerns with each alternative.

Most significantly, only the first two of these alternatives attempt to address Mobil's fundamental objections to the Proposed Rule. In the Comments of Mobil Oil Corporation on Proposed Rules Establishing Oil Value for Royalty Due on

Federal Leases, and on Sale of Federal Royalty Oil, dated May 28, 1997 (“Mobil Comments”), Mobil explained in great detail the business, economic, and legal impropriety of the Proposed Rule’s effort to ascribe value added by downstream marketing efforts to crude oil production at the lease. While the first two alternatives appear to address this concern, they are nonetheless plagued with some of the same flaws that underlie the Proposed Rule. Among these flaws is the unsupported and erroneous assumption that frequent or “reciprocal” transactions between oil companies, such as buy/sell transactions, are somehow anticompetitive or create incentives for parties to such transactions to underprice crude oil. See Mobil Comments Part IV.A. MMS’ recent Supplement also fails to address other substantial procedural, statutory, and practical problems associated with the Proposed Rule. See generally *id.* Parts I., V.

Therefore, Mobil reaffirms and incorporates by reference its comments (including all exhibits thereto) submitted in response to the original Proposed Rule on May 28 and the supplementary Proposed Rule on August 4. In addition, Mobil makes the following additional comments on the specific alternatives.

Alternative One

MMS’ first alternative is commendable in that it apparently attempts to adhere to MMS’ statutory mandate to collect royalties on the value of crude oil at the lease without including the value of downstream marketing efforts in its calculation. This alternative also appears aimed at valuing crude oil not sold in arm’s-length transactions in what Mobil believes to be the only economically

rational way to do so -- by use of comparable transactions occurring at the lease. Alternative One, however, apparently does not amend MMS' overly inclusive definition of non-arm's-length transactions, which remains fatally overbroad notwithstanding the improvement made in the July 3, 1997, Supplementary Proposed Rule. The Mobil Comments explain in great detail the problems with this definition and the unsound theories upon which it rests. Mobil also believes that, unless MMS reconsiders its definition of non-arm's-length transactions, any requirement that a minimum amount of production be tendered in any area is artificial and unsupported by any proper economic rationale.

Of course, whether or not Mobil can ultimately support a tendering valuation scheme will depend on the specifics of the tendering program that MMS proposes. For example, Mobil would not support a mandatory tendering requirement regardless of the specifics of the program. Moreover, a permissive program might be objectionable, for example, if the percentage of production required to be tendered was disproportionately high. Mobil needs further information to comment more fully.

Alternative Two

The second alternative is similar to the first and somewhat closer to existing regulations than any other proposal MMS has put forth. Under this alternative, when valuing crude oil produced from federal lands, a lessee would be required to look to a series of benchmarks, apparently designed to value the royalty

oil at the lease, whenever the transaction was deemed non-arm's length. These benchmarks include:

- (1) Outright sales of like quality crude in the field or area as described in Alternative 1;
- (2) The lessee's or its affiliate's arm's-length purchases from producers at the lease in the field or area;
- (3) Outright arm's-length sales by third parties;
- (4) Prices published by MMS based on its RIK sales; and
- (5) Netback employing price information from the nearest market center or aggregation point.

Supplement at 49462. Mobil understands that MMS has not determined whether these benchmarks would be considered in any particular order or examined separately or collectively. Notwithstanding, Mobil has the following comments regarding each of the proposed benchmarks.

First and Second Benchmarks

The first and second benchmarks would be acceptable to Mobil, subject to the same objections raised in response to Alternative One above. These benchmarks appear consistent with MMS' current statutory authority and adhere to the principle of using comparable lease transactions to value crude oil not sold in arm's-length transactions. Again, however, these benchmarks do nothing to address the overbroad definition of non-arm's-length transactions in the Proposed Rule.

Third Benchmark

The third benchmark would allow a lessee to value its production not sold at "arm's-length" by reference to outright arm's-length sales by third parties in the market area or region. Again, in the abstract, this alternative adheres to the principle of using comparable transactions at the lease to value crude oil, a principle that Mobil fully supports. The definition of non-arm's-length transactions remains an issue.

In addition, Mobil has practical concerns about this benchmark. For example, MMS will need to provide workable definitions of comparability, field or area, and other key terms. Without the definition of key terms, and unless MMS can better accommodate lessees' limited access to third party data, Mobil is not certain how MMS expects this proposed benchmark to work. Further details are needed before Mobil can comment fully. Moreover, Mobil continues to believe that arm's-length transactions at the lease regularly take place at posted prices. Those transactions would have to be included as part of this benchmark.

Fourth Benchmark

There is insufficient detail provided for Mobil to comment fully, however, as a general proposition, Mobil believes that, in areas where royalty-in-kind sales exist and are comparable, such sales could provide a reasonable benchmark. Mobil questions, however, whether MMS has sufficient royalty-in-kind sales in all fields to make this particular benchmark meaningful or whether MMS' royalty-in-kind sales will be comparable to other transactions at the lease in some circumstances. In addition, Mobil has concerns about how often prices for royalty-

in-kind oil will be published by MMS. Again, there is insufficient detail provided for Mobil to comment fully. As the Mobil Comments explained, however, many of these problems can be eliminated if MMS adopts what has been called the Canadian system and takes all of its crude oil in kind.

Fifth Benchmark

MMS has provided no details regarding the fifth benchmark. Thus, Mobil cannot meaningfully comment on this particular approach. To the extent that the netback to be used is the NYMEX-based methodology discussed in the Proposed Rule, Mobil has already discussed the substantial flaws in that approach in its original comments. Mobil adheres to the view, expressed in its earlier comments, that a netback method of valuation is appropriate only as a last resort when other, more appropriate benchmarks are not available.

Alternative Three

As a practical matter, Mobil does not believe that Alternative Three presents a workable valuation method. As Mobil understands the proposal, MMS would gather enormous amounts of pricing data from participants in the industry, attempt to construct the “market price” for each field or area where oil is produced from federal leases and apply those values to each transaction. There is no indication what transaction prices would be used or how often those prices would be collected and published. Presumably transactions at posted prices would be disregarded, which Mobil believes to be economically irrational. Mobil also questions how MMS will obtain information regarding crude oil sales that do not

involve government royalty oil. More importantly, the entire process would inevitably impose significant administrative costs and burdens on both the industry and MMS.

Alternative Four

Mobil strongly objects to this alternative to the extent it attempts to engraft portions of Mobil's May 14, 1997, proposed settlement in *E.M. Lovelace, Jr., et al. v. Amerada Hess Corporation, et al.*, Civil Action No. 96-297 (Cir. Ct. Escambia County, Alabama) as clarified on July 7, 1997, or Chevron's May 29, 1997 settlement in *The State of Texas, et al. v. Amoco Production Company, et al.*, No. 95-08680 (Dist. Ct. Travis County, Texas) onto the original Proposed Rule. Mobil has proposed a settlement of the *Lovelace* action simply to secure an end to groundless litigation filed against it by private royalty owners in recent years, not because there is any merit to any of the allegations in that case. The valuation methodology offered by Mobil and referred to in the Supplement is simply a compromise and is properly viewed as a renegotiation of the plaintiffs' royalty contracts with Mobil. MMS simply does not have the statutory authority to impose unilaterally its indexing methodology on Mobil or other federal lessees through rulemaking, formal or otherwise. Moreover, the valuation methodology included as part of Mobil's settlement of the *Lovelace* action is substantially different from the NYMEX-index methodology in the Proposed Rule. Mobil believes that netback methodologies are appropriate for valuing crude oil for royalty purposes only as a last resort, when other, more appropriate benchmarks are not available. Mobil also remains of the

view that MMS is not entitled to royalty on value added to crude by downstream marketing efforts. *See generally* Mobil Comments Part II.

Alternative Five

Under the fifth alternative, the netback approach in the Proposed Rule would be maintained but the netback would “start” with spot prices rather than the NYMEX. The alternative does not specify what spot prices MMS intends to rely upon, how those prices would be determined, how often they are updated, or even whether reliable spot prices are available for all fields or market areas. Mobil assumes that, under this alternative, MMS expects to use published spot prices at certain “market centers” and then netback to the particular field or lease at issue. To the extent this alternative envisions using the same netback methodology set forth in the Proposed Rule but merely starts with a different reference price, it suffers from all of the same problems that the Mobil Comments noted with the original NYMEX-based netback proposal.

CONCLUSION

Mobil appreciates the opportunity to comment on the alternatives and to present its views. While the first two alternatives appear to be a step in the right direction and, in the abstract, superior to the original Proposed Rule, none of the alternatives are sufficiently concrete or adequately developed to allow Mobil to comment in-depth or to support fully any specific proposal. Mobil remains of the view that MMS should withdraw its Proposed Rule and rethink its proposal.